

ON THE ROAD TO CAPITAL ACCOUNT CONVERTIBILITY

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Introduction :

The capital account records all international transactions that involve a resident of the country concerned changing either his assets with or his liabilities to a resident of another country. Transaction in the capital account reflect a change in a stock either assets or liabilities. With regard to the capital account transactions it is useful to make a distinction between various forms of transaction. The basic distinction is between private and official transaction, between direct and portfolio investment and by the term of investment. The bulk of official transactions is in the form of loans and concessional assistance from external official agencies such as IMF, foreign governments and also includes commercial borrowing. On the other hand, the bulk of foreign investments are private.

Foreign Direct Investment (FDI) refers to such investment involving the act of purchasing an asset and at the same time acquiring control over it. The acquisition of a firm by a resident in another country is an example of the transfer of funds from the parent company in order that the subsidiary company can acquire assets in its own country. FDI mainly occurs through multinational corporations.

Portfolio investment by contra is the acquisition of an asset that does not give the purchase control over the asset. The purchase of shares in a foreign company or of bond issued by a foreign government is an obvious example of such a transaction. Such portfolio investment is often distinguished by the period of the investment, between short-term and long-term investment. However, this distinction relates to the specification of the asset rather than to the length of time for which it is held. For instance, a firm or individual that hold a bank account in other country, will be engaging in short-term investment even if the intention is to keep that money for many years and buying a long-term government bond in another country will be making a long-term investment, even if that bond has only one month mature.

The purchase of an asset in another country, whether it is direct or portfolio investment, will appear as a negative item in the capital account for the purchasing country and as a positive item on a country's balance of payments and capital inflows as positive items. The net value of the balance of direct and portfolio investment defined the country's balance on capital account.

Apart from the above transactions, the BOPs accounts are completed by the entry of other minor items that do not fall comfortably into one of the standard categories. Errors and omissions and changes in official resources. Errors and omissions or the balancing item reflect transactions that have not been recorded for various reasons and which reflects the difficulties involved in recording accurately a wide variety transaction. In some cases there is such a large number of transactions that a sample is taken target than recording each transaction, inevitably resulting in errors. In others, problem arises when a transaction takes more than one year. Dishonesty may also play a part as when goods are smuggled or due to under reporting of some items in order to reduce tax liabilities. Thus errors and omission must be included to make the full BOPs account sum to zero.

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As per Section 2(e) of FEMA 1999, Capital Account Transaction means a transaction, which alters the assets or liabilities, including contingent liabilities, outside India of persons resident in India, or assets or liabilities in India of persons resident outside India, and includes transactions referred to in Sub-Section (3) of Section.

The transactions referred to in the aforesaid Sub Section (3) of sections are as follows :

- a) Transfer or issue of any foreign security by a person resident in India.
- b) Transfer or issue of any security in Rupees by a person resident outside India;
- c) Transfer or issue of any security or foreign security by any branch; office or agency in India of a person resident outside India;
- d) Any borrowing or lending in foreign exchange in whatever form or by whatever name called, between a person resident in India and a person resident outside India.
- e) Any borrowing or lending in foreign exchange in whatever form or by whatever name called, between a person resident in India and a person resident outside India.
- f) Deposits between a person resident in India and a person resident outside India;
- g) Exports, Import or holding of currency or currency notes;
- h) Transfer of immovable property outside India, other than a lease not exceeding five years by a person resident outside India;
- i) Acquisition or transfer of immovable property in India, other than a lease not exceeding five years by a person resident outsider India;
- j) Giving of guarantee or surety in respect or any debt, obligation or other liability incurred.

Convertibility of Currency (CC)

Convertibility of Currency means that the currency can be exchanges for any other convertible currency, without any restriction, at the market determined exchange rate. Thus it means that the rupee can be freely converted into dollar, pound sterling, yen Deutsche mark, etc., and vice versa at the rates of exchange determined by the demand and supply forces.

In a broader way the currency convertibility means instituting exchange arrangements whereby residents, non-residents and foreigners can exchange (transform) freely (without limit) domestic currency for (into) any foreign currency or gold and vice versa at a predetermined (fixed) or a variable but legal (not unofficial or parallel) market rate of exchange for the purpose of transactions on trade, invisible, current and capital accounts.

Currency convertibility does not have just one meaning. It's meaning has undergone changes over the years. In the 19th century, a currency was deemed convertible only if non-residents should obtain gold at a fixed price with their currency balances. Under the Bretton Woods system, it implied an official obligation to transform domestic currency balances of non-residents into the currency demanded by them, at the parity to be maintained with the IMF framework. According to one working definition, "currency is convertible if domestic nationals wishing to buy foreign goods and services.... can freely sell domestic for foreign currency.... at a single but possibly variable foreign exchange rate covering all current transactions inclusive of normal trade credit, whereas foreigners (non-residents) with balances in domestic currency arising from current transactions can sell them at the same foreign exchange rate or purchase domestic goods freely at prevailing domestic currency prices."

Capital Account Convertibility (CAC)

Capital Account Convertibility implies freedom to convert rupees into foreign currency for transactions on current on current account. On the other hand "CAC refers to the freedom to convert local financial assets into foreign financial assets and vice versa at market-determined rates of exchange. It is associated with changes of ownership in foreign/domestic financial assets and liabilities and embodies the creation and liquidation of claims on, or by, the rest of the world." Capital account convertibility can help increase the inflow of foreign capital, under certain conditions, as it enables the foreign investors to repatriate their investments whenever they want. But it could also lead to flight of capital from the country if domestic conditions are unfavorable.

Hence, capital account convertibility is usually introduced only after experimenting with the current account convertibility for a reasonable time, stabilization programmes have been successfully carried out and favorable conditions have been ensured. The introduction of capital account convertibility at least for certain types of capital flows helps in attracting resources from abroad. It also enables residents to hold internationally diversified investment portfolios, thereby, having more risk bearing capacity.

Benefits

There are distinct benefits of CAC, such as :

- 1) Development of financial markets and a disciplining influence on macro economic polices.
- 2) It also enables the country to integrate its economy with global economy thereby facilitate greater access to international financial markets to obtain larger stock of foreign capital at relatively low costs, to supplement domestic capital resources.
- 3) A two way movement of capital and increased flow of foreign capital especially in portfolio form is likely to lead to a fall in interest rates.
- 4) This would boost the investment and GDP growth.
- 5) It also allows domestic residents to invest in foreign markets.
- 6) By diversifying their investment portfolio they can reduce the risk factor.
- 7) Further it facilitates specialization in financial services and thereby increases allocative efficiency and productivity of capital.
- 8) When a currency becomes convertible on capital account, financial price, both domestic and international, tend to level off as capital can move both ways without any hindrance. This leads to a fall in domestic tax regime in line with tax regimes elsewhere. Moreover, it has to be noted that over a period of time capital controls turn ineffective, costly and even distorting.

Problems

The convertibility would cause some problems unless certain conditions are satisfied.

- 1) Convertibility could cause an increase in prices because of the increase in the import prices.
- 2) Under full convertibility, if the free market exchange rate is very high, the cost of essential imports will correspondingly increase.
- 3) If the current account balance is not kept under control, the free market rate would rise very high.

CAC – Indian Scenario

The convertibility of the Indian rupee has been a subject o great interest and exited discussion s in

recent years. The submission of the report of the committee on Capital Account Convertibility (CCAC), at the end of May 1997 has given a fresh impetus to them. At the time of submission of the said report, the situation in India was mixed in the sense that there was no full current account convertibility (CURAC) and there was capital account convertibility (CAC) in certain respects. However the CCAC thought that the time was now apposite to initiate a move towards CAC and it recommended that the implementation of CAC be spread over a three-year period i.e., 1997-2000. It also recommended the liberalization of both capital inflow and outflows. In its view, fiscal consolidation, a mandated inflation target and strengthening of the financial system were the crucial preconditions/sign posts for CAC in India. Is the committee right in its thinking.

However, recognizing the pros and cons of CAC the Tarapore committee on CAC has recommended a phased implementation of convertibility on capital account over a three years periods (1997-98, 1999-2000). The implementation of measures contemplated for each phase should be based on a careful and continuous monitoring of certain pre-conditions and attended variables identified from the lessons of the international experiences. The committee has recommended that fiscal consolidation, a mandated inflation target and strengthening of the financial system should be regarded as crucial signpost for convertibility of rupee in India these congenial conditions are required to be met for CAC to be successful. It has been recommended that the center's gross fiscal deficit to GDP ratio should be reduced from 4.5p.c. in 1997-98 to 3.5p.c. in 1999-2000. This should be accompanied by a reduction in state governments deficit also.

The Agenda for Capital Account Liberalization

Capital account convertibility has become our agenda for quite some time. In view of the many disturbances that have taken place in international capital markets in recent years. It is proposed to continue with the policy of liberalization with caution. Accordingly, Government in its union budget for 2002-2003 proposed the following steps to further liberalise the capital account.

- 1) There will be full convertibility of deposit schemes for Non Resident Indians. The existing Foreign Currency Non-Resident (FCNR) B scheme and the Non- Residential External rupee (NRE) scheme will continue to be repatriable.
- 2) The schemes, which do not offer full convertibility to NRIs, will be discontinued from April 1, 2002. The existing balances in the non-resident (non-repatriable) rupee accounts will be allowed to be credited on maturity to the convertible NRE account.
- 3) NRIs will be free to repatriate in foreign currency their current earnings in India such as rent, dividend, pension, interest and the like based on appropriate certification.
- 4) Indian companies wishing to invest abroad may now invest up to US 100 million dollars on an annual through the automatic route up from the existing limit of US 50 million dollars.
- 5) Indian companies making overseas investments in joint ventures abroad by market purchase may now do so without prior approval up to 50 percent of their net worth, up from the current limit of 25 percent.
- 6) Corporate with proven track record will be allowed to contribute funds from their foreign exchange earnings for setting up chairs in educational institutions abroad and for other welfare measures, likely to benefit the community abroad, on a case by case basis by the RBI.
- 7) Indian mutual funds will now be allowed to invest in rated securities in countries with fully convertible currencies, within the existing limits. Earlier such investment was only permitted in ADR/GDRs issued by Indian companies in overseas markets.

- 8) Pre-payments of ECBs is permissible to the extent of balances available in EEFC accounts, which are currently restricted to 50 percent of export proceeds. To enable ECB holders to benefit from lower interest rates, utilization of higher amounts from export proceeds will be considered by RBI.
- 9) With a view to further liberalizing the capital account transactions it is proposed to put the Foreign Currency Convertible Bond (FCCB) under the automatic route upto US 50 million dollars.

The Reserve Bank of India will be issuing guidelines for each of these measures separately.

While liberalizing the capital account is necessary we have to exercise careful vigilance in curbing illegal capital flows. Recent evidence indicated transfer of large sums of money through various channels in support of terrorist activities in the country. The Government, therefore, proposes to bring suitable legislation during the current session of Parliament to empower the enforcement agencies to arrest and prosecute the hawala operators/money launderers suspected to be engaged in financial transactions linked with terrorist activities.

The full convertibility model advocated by IMF economists is not suitable for the developing countries. But the IMF got its articles of agreement amended recently to make CAC a mandatory one on all member countries and to prescribe CAC as a pre-condition for fund membership. In CAC environment, there are no restrictions in the movement of capital account transactions from domestic market to international market. If rupee is not fully convertible on current account it does not mean that it is not convertible on capital account where there are no restrictions on capital inflows. And for some categories of capital outflows such as royalty payments, the rupee is convertible, as fee repatriation is permitted.

Pre – Conditions For Implementing The CAC

The following are the pre-conditions for implementing the CAC.

1. Slash or subsidies provided by the Government in different sectors of the economy.
2. Control /Cut-down of non-plan expenditure to the barest minimum level
3. Reduction in the deficit in the Annual Fiscal Budgets.
4. Fast/quick implementation of dis-investment of Forex
5. Deploying foreign funds for productive use, i.e. in growth oriented sectors.
6. Increasing the base levels of Forex reserves of the country.
7. Strengthening of the Balance of Payments, unparticular, current account transactions.
8. Control of/reduction in the inflation rate in the economy within manageable levels
9. Gearing up the economic/financial reforms in the country.
10. Strengthening the capital base levels of Indian banks on par with International banks.
11. Improvement in the Standard Assets of the Banking Sector and the reduction in NPSs to internationally accepted levels.
12. Increase in the efficiency of commercial Banks, reduction in their operating costs, developing risk management skills, modernizing management, pressing into service modern technology to raise productivity, etc.,
13. Implementing reforms both in Primary and Secondary capital markets in order to attract foreign capital NRIs, OCBs and FILs for development of infrastructure projects and industries such as

cement, steel, road and bridge construction, capital goods, telecom etc, in the country Introduction of wide range of derivatives such as futures, options, etc.

14. Implementation of International reporting norms such as International Accounting Standards, GAAP, etc., in Indian companies to attract inflow of foreign capital through ADRs/GDRs, etc.

Conclusion

Indian economy is not strong enough to allow capital convertibility because the stock markets are not in a position to absorb the heavy shock waves likely to be created, price rise, high import cost uncontrollable outflow of capital, serious balance of payments problems etc. as a result of capital account convertibility.

Despite the problems avowed, there are, no doubt, several benefits to capital account convertibility. Particularly India as a developing country needs foreign investments to boost her economy and investors, before she puts her money on the table, would expect the country to operate in a free economic environment with a free capital market. The attractiveness of a country for foreign investment, however, depends on many factors, and a free currency policy is just one of them.

However India can go ahead for the policy of cautious movement towards capital account liberalization. We should treat liberalization of capital account as a process and not as a single event to be embarked upon cautiously as part of overall economic reforms in our country as well as our assessment of emerging scenario elsewhere. But India should meet the pre-conditions before full convertibility of rupee on Capital Account.

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